



**Election 2006**

## **Key Questions**

**VOTERS SHOULD ASK CANDIDATES ABOUT THE  
BUDGET AND OUR NATION'S FISCAL FUTURE**



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COALITION**

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## **Key Questions**

### **Voters Should Ask Candidates About the Budget and Our Nation's Fiscal Future**

The Concord Coalition is a nonpartisan grassroots organization that advocates fiscal responsibility. We believe that America should prepare now for the enormous fiscal challenges our country will face when the baby boom generation leaves the workforce and begins to collect Social Security in 2008 and qualify for Medicare in 2011.

Under reasonable assumptions, budget deficits could easily exceed \$5 trillion over the next 10 years. The long-term outlook is even worse. That is why analysts of diverse ideological perspectives warn that current fiscal policy is unsustainable and that the best time to change course is now. Because the only realistic options are politically difficult, the active involvement of the American people is critical to finding solutions.

The following questions provide a framework for ensuring that candidates address some of the toughest choices they will face concerning the federal budget if they are elected. Background information is given to provide context and to help with follow-up questions, which should be asked whenever you believe that you have not been given a complete answer.

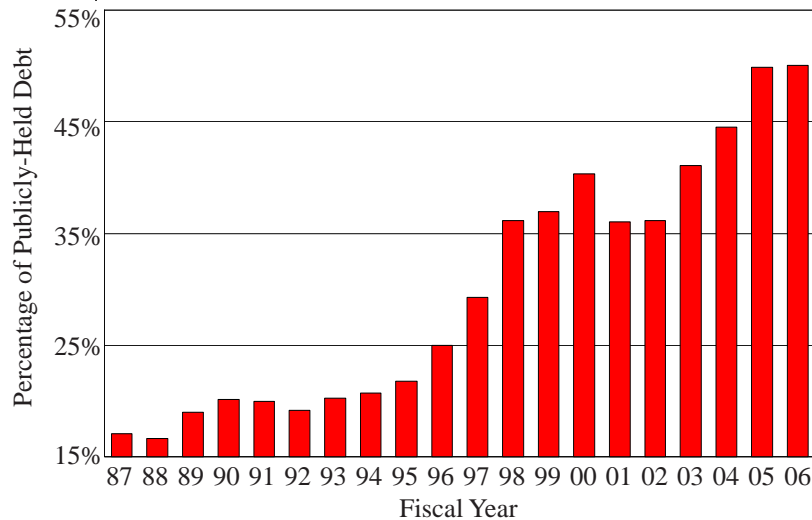
*Do you believe that large sustained budget deficits pose a threat to our nation's economic future?*

If deficits don't matter then there is no reason for politicians and the public to worry about them. After all, most people would like to have more government services with lower taxes. That's why politicians often sound like Santa Claus as they toss gift-wrapped benefits and free lunch tax cuts from their bag of campaign rhetoric. While many politicians are tempted to downplay the importance of deficits in election years, it's a dangerous game. Like being drawn into an addiction, deficits are easy to acquire and hard to get rid of.

To be clear, no single year's deficit will harm the economy. It is the accumulation of large deficits, year after year, that burdens taxpayers and undermines future living standards. It does so by soaking up national savings and crowding out productive investment. It also puts upward pressure on interest rates, reduces the fiscal flexibility to deal with unexpected developments, and raises the cost of interest payments on the national debt. In 2005, the government paid interest costs of \$184 billion — equivalent to what it paid for the Medicaid program.

Borrowing from domestic lenders to finance government deficits leaves less money for the building blocks for our economic future — research and

## Share of Publicly-Held Debt Owned by Foreigners



Source: United States Department of Treasury

development, investing in plants and equipment, educating our children and training our workers. Borrowing from foreign lenders is an alternative. In fact, the portion of our debt held by foreign investors has risen dramatically since 2001 — from over 35 percent to over 50 percent. However, there are distinct downsides to reliance on foreign capital. It increases the budget's exposure to international capital markets and decisions made by foreign interests. If for any reason, foreign investors and central banks reduce their lending to the United States this would drive up interest rates for the federal government and everyone else. Moreover, interest payments on the national debt go to bond holders from abroad and drain financial resources away from the U.S. economy. This acts as a growing mortgage on future national income.

Beyond fiscal imbalance, the policies embedded in today's budget threaten to place ever-tighter constraints on the ability of future citizens and policy makers to determine their own fiscal priorities. The share of federal resources pledged to aging baby boomers and the generations immediately preceding them is growing, leaving shrinking amounts for all other purposes. The United States would be in a stronger position to weather difficult times, address emerging national needs and invest in future economic growth if it had greater flexibility and strength in its fiscal position.

We could cross our fingers and hope that the U.S. economy is sufficiently resilient to overcome anticipated fiscal challenges without any change to current policies. However, this outcome is highly unlikely and, in any event, wishful thinking is not a prudent fiscal strategy. A far more prudent and secure path to

bettering the fiscal outlook would be to reassert control over fiscal policy and restore budget discipline.

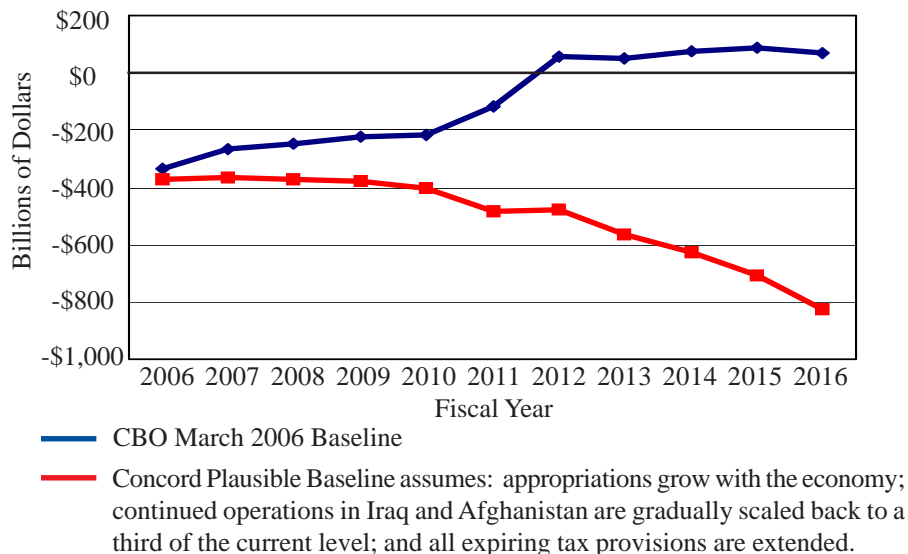
*Do you believe that Congress and the President should agree on a plan to balance the budget?*

After having budget surpluses from 1998 through 2001, we are back to facing endless deficits that will not go away without specific actions by Congress and the President. Under realistic estimates, deficits will remain near or above \$300 billion for the rest of the decade. Analysts of diverse ideological perspectives and nonpartisan officials at the Congressional Budget Office (CBO) and the Government Accountability Office (GAO) have warned that current fiscal policy is unsustainable over the long-term.

Instead of working on a plan to bring the deficit under control, politicians in Washington have indiscriminately cut taxes, increased spending, allowed budget enforcement rules to expire and ignored the long-term dangers of large chronic deficits.

Without the discipline imposed by a firm fiscal policy goal, deficits are likely to go higher and last longer than they would otherwise. The one goal that has

### Current Policy Trends Lead to Large Sustained Deficits



Source: Congressional Budget Office and Concord Coalition Analysis, March 2006

recently gotten some attention is cutting the deficit in half by 2009. Adherence to this goal is often cited as evidence of a commitment to fiscal discipline and to ease fears of a rising deficit. However, the goal of cutting the deficit in half by 2009 is inadequate relative to the fiscal challenges we face. A candidate who supports this goal is actually signaling a significant retreat from the bipartisan balanced budget consensus that developed in the 1990's.

While any promise of deficit reduction is a plus — because it acknowledges that the deficit is a problem—the halfway goal trivializes the full magnitude of the fiscal challenges ahead and does little to prepare the nation for the kind of hard choices that will eventually be required to bring about a sustainable fiscal policy. After the next five years, projections are for a ballooning deficit due to rising entitlement costs and, if enacted, extensions of expiring tax cuts.

Instead of allowing this to happen, policymakers should return to the bipartisan balanced budget consensus of the 1990's. Balancing the budget within 10 years is an achievable goal that would: 1) lower government borrowing from the financial markets and 2) provide a much needed boost in national savings to help the budget and the economy meet the challenges of an aging population.

The best way to do this is for policymakers to put everything on the table—including entitlement cuts and tax increases—and negotiate the necessary tradeoffs. If leaders put the national interests ahead of partisan or parochial interests they could develop a specific and realistic plan to put the country on a sustainable long-term fiscal path.

*Do you support reinstatement of caps on annual appropriations and pay-as-you-go rules for taxes and entitlement spending?*

Although budget rules alone will never be able to solve the nation's fiscal problems, enforcement mechanisms can bring greater accountability to the budget process and help provide Members of Congress with the political cover to make the tough choices necessary to reduce the deficit. Pay-as-you-go rules (PAYGO) for all tax and entitlement legislation and spending caps for appropriations are proven tools for fiscal discipline. These enforcement rules, enacted in 1990 and extended in 1997 with bipartisan support, were an important part of getting a handle on the deficits in the early 1990s and getting the budget back into balance. Unfortunately, Congress allowed these rules to expire in 2002.

Reinstating PAYGO rules and spending limits on appropriations alone would not balance the budget, but doing so would represent an important first step in

bringing discipline to the budget process. Statutory caps on appropriations helped hold such spending flat from 1991 to 1996 and restrained its growth to 3.7 percent a year between 1996 and 2000. The PAYGO rules required anyone proposing tax cuts or entitlement expansions to answer the question: “How do you pay for it?” Renewing the discipline imposed by an answer to this question is perhaps the most important thing politicians can do in the short-term to restore fiscal discipline in Washington.

Pay-as-you-go rules do not prevent Congress from passing tax cuts and entitlement spending increases. Rather, they simply require that if Congress wants to do these things they must do so in a deficit neutral way. Those who want to extend expiring tax cuts or enact additional tax cuts should be willing to put forward the spending cuts or other offsets necessary to pay for them. Similarly, those who want to spend more in certain areas need to be willing to say where they would cut or how they would raise revenues to pay for their proposals.

Several proposals have been put forward applying PAYGO rules to spending while exempting tax cuts. The only common sense way to restore fiscal discipline is to apply budget rules to all legislation that would increase the deficit. Since spending and tax decisions both impact the budget, there is no good reason to exempt either from enforcement rules. Moreover, exempting tax cuts from PAYGO would encourage an expansion of so-called ‘tax entitlements’ where benefits are funneled through the tax code rather than by direct spending, a far less efficient approach. In addition, prohibiting tax increases from being used to pay for entitlement spending increases under PAYGO rules would create the dangerous notion that debt is a painless alternative to raising the revenues necessary to pay for entitlement benefits.

*What specific spending cuts would you propose to help balance the budget?*

Politicians often talk tough on spending without mentioning what programs they would cut. This is a convenient way to avoid making hard choices. Evaluating how serious a candidate is about spending restraint requires some perspective on the dimensions of the budget and the deficit.

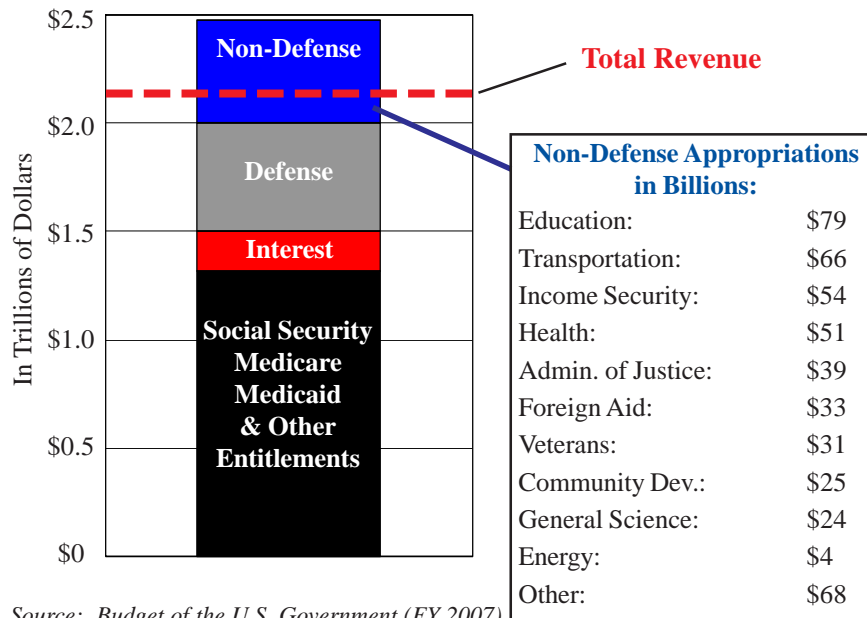
In 2005, the government spent \$2.47 trillion and ran a deficit of \$318 billion. If Congress had been required to balance the budget without raising taxes, it would have had to enact a 14 percent cut in all federal programs — not an easy task. But if Social Security, Medicare and Medicaid were exempted, the cut would have been 25 percent. If national security programs were also

exempted the cut to all other programs would have been almost 50 percent. Nobody would suggest such a thing, but these numbers demonstrate that exempting popular programs from fiscal scrutiny is not a viable strategy for balancing the budget and that simply cracking down on everyone’s favorite targets “pork” or “waste, fraud and abuse” is not enough to get the job done.

It is impossible to cut spending without cutting something that someone wants in the budget. If everyone insists on only cutting someone else’s priorities, talk about deficit reduction will remain just that.

Since 2001, military operations in Iraq and Afghanistan have added roughly \$400 billion to federal expenditures — including \$120 billion that Congress has already approved for 2006. Historically, the American people have been extraordinarily willing to sacrifice in order to better equip the nation for whatever its leaders deemed necessary. During World War II and the Korean War, Presidents Roosevelt and Truman proposed major cuts in domestic spending while raising taxes substantially. Very few political leaders ask for sacrifice now, even in a time of war. Our leaders need to again make hard choices that will allow us to confront challenges without passing all the costs to future generations.

**Composition of Actual 2005 Federal Budget**  
(2005 Deficit: -\$318 Billion)



Source: Budget of the U.S. Government (FY 2007)

*The tax cuts passed since 2001 are set to expire by 2011. Do you support extension of the expiring tax cuts and, if so, how would you address the budgetary implications?*

Since January 2001, Congress has enacted four tax cut packages with “sunset” provisions that cause them to expire at the end of 2010. Circumstances have changed dramatically since the bulk of these tax cuts were enacted in 2001. The surplus era in which the tax cuts were enacted has been replaced by deficits as far as the eye can see, and the budget faces new demands for the war on terrorism and homeland security. Moreover, policymakers have not taken action to prepare for the costs of the baby boomers’ retirement and health care needs that will begin to place a growing strain on the budget in the years ahead. In fact, they dramatically increased the cost by enacting a Medicare prescription drug benefit.

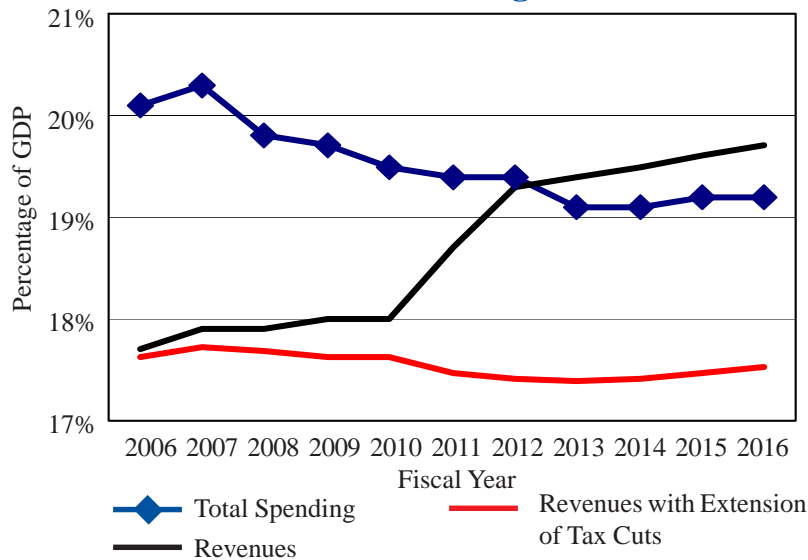
In light of all of this, it makes sense to reassess whether we can afford to continue all of the tax cuts enacted in the surplus era. A logical response to the dramatically changed budgetary conditions would be to rescind or scale back some of the tax cuts and offset any of the expiring tax cuts Congress chooses to extend.

Some argue that the recent increase in government revenue proves that tax cuts have not increased the deficit because they “pay for themselves” through greater economic growth. However, a look at revenue trends over the last few years shows that optimistic assertions regarding the effect of tax cuts on revenue growth are not supported by the actual data. Fiscal Year 2005 saw a large increase in revenue from FY 2004—up by 14.6 percent to \$2.15 trillion. While this was a record in dollar terms, larger than the previous record of \$2.02 trillion in 2000—it still represented a much lower percentage of the economy (GDP) than in 2000—17.5 percent of GDP as opposed to 20.9 percent. Revenues in 2005 were approximately \$140 billion *lower* than 2000 revenues adjusted for inflation.

Setting a record for revenues in nominal dollars is not remarkable; revenues almost always set a record in nominal dollars every year as revenues naturally increase with inflation, economic growth and other factors. What is remarkable is that revenues *did not* set a record in the previous four years and the record set in 2000 was not broken until 2005. Between 2001 and 2003 revenues actually declined for three years in a row for the first time since the 1920’s. It is also important to note that the \$2.47 trillion of spending in 2005 was also a record in dollar terms.

While total revenues in 2005 finally climbed back above 2000 levels in nominal dollars, revenues from individual income taxes were still well below 2000 levels. Total revenues in 2005 exceeded 2000 levels not because of increases in individual taxes, but primarily as a result of the steady growth in payroll tax revenues (which have increased from \$653 billion in 2000 to \$794 billion in 2005) and to a lesser extent the surge in corporate tax collections (\$278 billion in 2005 compared to \$207 billion in 2000).

### Effect of Extending Tax Cuts



Source: Congressional Budget Office, January 2006

Voters should be wary of drawing an inevitable connection between tax cuts, economic growth and higher revenues. For example, in the five years following the tax *increases* of 1993, annual real economic growth averaged 3.8 percent. In the five years since the tax cut policies began in 2001, annual real economic growth has averaged 3.1 percent. Moreover, in the five years after the tax *increases* of 1993, annual revenue growth averaged 8.3 percent. In the five years after the tax cut policies began in 2001, annual revenue growth has averaged 4 percent. These numbers certainly do not establish that tax increases are better for the economy than tax cuts, but they do establish that tax cuts enacted over the past few years are not necessarily needed beyond their expiration date to ensure economic growth. The best fiscal policy is one that balances spending and revenues at a sustainable level over the long-term.

It is true that some tax cuts can add to short-term economic growth in certain circumstances, but not by enough to increase federal revenues beyond what

they would have been. Economists from the left and right generally acknowledge that tax cuts do not fully pay for themselves through greater economic growth. Thus, extending the tax cuts in full will require Congress to make substantial spending cuts, raise other taxes or significantly increase the national debt.

*Do you support the hard choices and tradeoffs inherent in fiscally responsible tax reform?*

The amount of revenue raised is determined by both the tax base (what is taxed) and the tax rate. The more income left out of the tax base, the higher the tax rate must be to raise the same amount of money as under the present system. Tax reform plans that have generous income exclusions (such as for standard and dependent deductions, home mortgage interest, charitable giving and investment income) *and* lower tax rates may sound attractive but they simply won't raise the same amount of revenue as the current system — even with all its flaws.

Revenue neutrality has traditionally been a goal of tax reform. However, that means tax reform requires tradeoffs. Such choices, as those recommended by a recent bipartisan panel appointed by the President, include: the repeal or scaling back of several existing tax breaks, limiting the deductibility of employer-provided health care, limiting the home mortgage interest deduction, and repealing the deductibility of state and local taxes. Voters should be skeptical of politically popular tax reforms that don't make trade-offs to offset the revenue loss that can result. Plans that rely on unprecedented economic growth or unspecified spending restraint to add up should be viewed with special skepticism.

Several proposals have been put forward intended to simplify the tax code, promote economic growth, and encourage savings and investment, among other objectives. Policymakers have also pointed to tax reform as the vehicle for confronting the growing reach of the Alternative Minimum Tax (AMT), a tax system that is quickly ensnaring the middle class with higher taxes than the regular income tax would otherwise subject them to — in effect a backdoor tax increase taking away benefits of the recent tax cuts. Congress has been tinkering with the AMT on a year-to-year basis, sewing uncertainty into the tax code and hiding future revenue losses. Real tax reform that eliminates or provides a permanent “fix” of the AMT would need to close loopholes and eliminate some deductions in order to produce at least the same amount of revenue as the current tax system. Similarly, many reforms encouraging savings

and investment would result in lower revenues that would need to be replaced to avoid increasing the deficit.

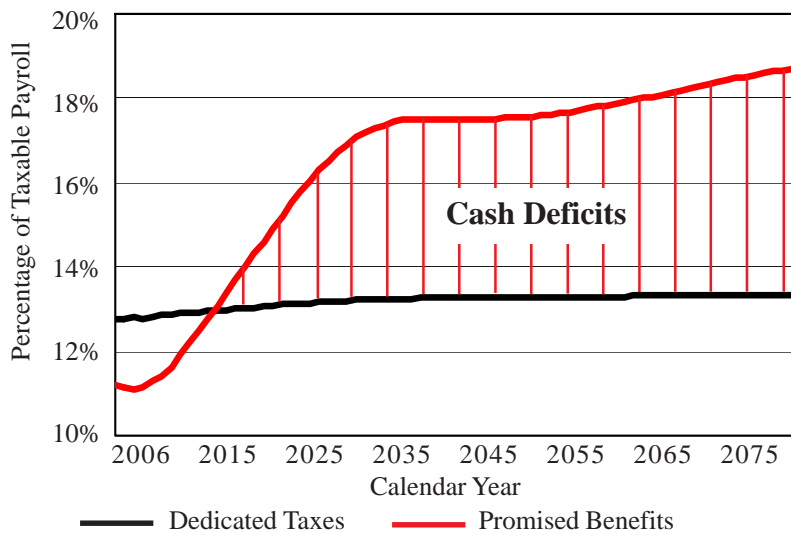
While failure to support fundamental tax reform proposals represents a lost opportunity to improve the fairness and efficiency of the tax code, any decision to support politically popular and expensive elements of tax reform without embracing tradeoffs to offset the revenue loss is much worse from a fiscal perspective.

*What steps would you take to close Social Security's long-term funding gap?*

Over the next 30 years, as today's children move into the workforce and today's workers begin to retire, Social Security will place a mounting burden on the budget and the economy. By 2035, the program's projected annual cost of \$1.3 trillion (adjusted for inflation) will equal 6.4 percent of GDP and 17.4 percent of taxable payroll, an increase of roughly 50 percent above current levels. Any reform of the system must acknowledge and address this cost growth.

The bottom line is that there are just two ways to address Social Security's financing gap without over burdening tomorrow's workers and taxpayers: 1) reduce Social Security's long-term cost and 2) make the remaining cost more affordable by increasing national savings and hence the size of the future economy. A workable reform plan should do both.

### Promised Benefits Far Exceed Dedicated Taxes



Source: Report of Trustees of the Social Security Trust Fund, 2006

Candidates who promise to preserve benefits at the levels promised under current law must explain where the money will come from to fund these promises. Likewise, candidates who promise to oppose any tax increases must explain what changes they would make to restrain the growth of Social Security costs to stay within current tax levels.

Finding a cure for what ails Social Security won't happen without sacrifice — a reality most lawmakers have not accepted. But “painless” solutions that don't ask anyone to accept less or pay more will neither reduce the long-term cost of the program, nor contribute to a larger economy so that the remaining costs will be more affordable. Reform efforts must focus on how much Social Security is going to cost over the long-term and how future taxpayers are going to pay for those costs.

It is true that the Social Security trust fund shows a positive balance through 2040. However, trust fund solvency is a misleading measure of the program's long-term viability. Social Security cannot be viewed in isolation from the overall federal budget. The trust fund is simply an accounting device keeping track of the program's claims on general revenues with “assets” consisting of Treasury IOU's. It says nothing about how society will meet the growing fiscal burden reflected in those trust fund balances. The key point is that the trust fund assets are also taxpayer liabilities.

What matters fiscally and economically is Social Security's cash balance—that is, the annual difference between outlays and earmarked tax revenues. Social Security will begin running annual cash deficits in 2017. Between 2017 and 2040, the U.S. Treasury will have to come up with more than \$4.2 trillion in today's dollars to redeem the bonds in the trust fund. In order to generate the cash to pay these IOU's, policymakers will need to cut spending on other programs, raise taxes, or borrow the money. Stemming the cash hemorrhage would ultimately require cutting benefits by one-third or raising payroll taxes by one-half. Thus, the existence of trust fund balances on paper does not change the fact that Social Security will place tremendous pressures on the rest of the budget and future taxpayers as well as the economy as a whole.

Approximately 55 percent of the rise in Social Security's cost over the next 75 years is due to an increase in the number of beneficiaries and improvements in life expectancy. The remaining 45 percent is due to a projected increase in the value of the benefits, which are indexed to wage gains rather than prices. This means that the “real” (inflation adjusted) value of benefits increases for each new group of recipients. If the aim of reform is to address Social Security's financing problem at its source, two ideas to gradually constrain cost growth

would be to adjust eligibility for increasing longevity or to index initial benefit levels to price increases rather than wage increases. Neither of these options would change benefits for current recipients.

Higher economic growth alone will not significantly change the Social Security financing burden. Social Security costs tend to increase with economic growth because initial benefit levels are linked to wage growth. Faster economic growth may modestly improve long-term actuarial balance of the trust fund, but it does so by swelling the trust fund with increased short-term revenues without addressing the long-term financing shortfalls.

Currently, the Social Security payroll tax (12.4 percent) is capped at \$94,200 of wages. One popular idea for helping to solve Social Security's long-term financing problem is to make more of the earnings of higher income workers taxable by raising the cap. As a means of assuring the program's sustainability, this would be considerably less effective than proponents allege. It would only provide a few more years of positive cash flow to the system and, unless the link between taxable earnings and benefits were to be eliminated, it would add to the system's long-term cost by providing higher benefits to those who need them the least. Higher revenues today will do nothing to lessen Social Security's future burden without a mechanism to ensure that the extra money is translated into higher savings and a larger future economy rather than higher spending.

Ultimately, a real solution that boosts national saving and achieves a fiscally sustainable system requires more than raising the tax cap. The primary source of the nation's long-range fiscal strain is not on the revenue side of the equation, but on the spending side, and the most effective long-range saving measures would be those that constrain the growth of federal entitlement programs.

Voters should be wary of assertions about how much reform plans would cut benefits below the level *promised* under current law, because current law makes promises we can't keep without substantially raising payroll taxes. Under virtually all reform plans, future benefits will be as high or higher than benefits paid today adjusted for inflation. The question is how much faster should benefits be allowed to grow and how the funds will be generated to cover these growing costs.

*What is your opinion about including individual accounts in Social Security reform legislation?*

Individual accounts can be an important component of a comprehensive reform plan, but they do not provide a painless solution to the financial challenges

facing Social Security. Personal accounts have potential advantages over the current system, including higher returns on worker contributions and providing a more reliable method of pre-funding benefit promises than government trust funds.

However, they are not a free lunch. Money to fund the accounts must come from somewhere. If they are financed solely by issuing additional debt, no new savings for the economy will result, as the increase in government borrowing would cancel out the “savings” in personal accounts. Moreover, individual accounts alone do nothing to close the existing gap between dedicated revenues and promised benefits. In any true transition to a funded system, workers will have to pay more, retirees will have to receive less, or both. Reform plans that do not face up to this transition cost will not result in new net saving or a larger economy.

Individual accounts are not a substitute for reforms that would directly close the program’s financing gap by reducing future benefits or increasing revenues. With or without individual accounts, some combination of these options will be necessary. However, simply opposing individual accounts is not an answer to Social Security’s fiscal problems.

*Medicare is in worse shape than Social Security. How do you propose to make Medicare affordable?*

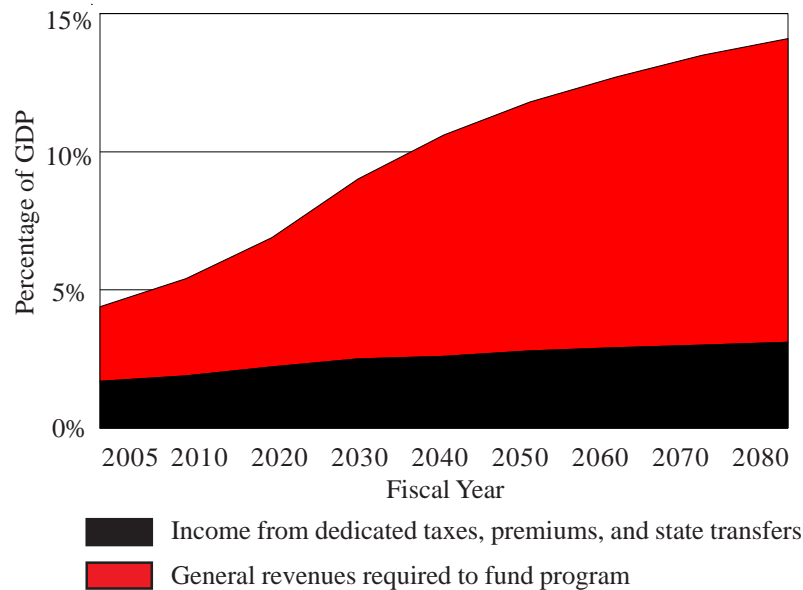
Medicare is the second-largest social insurance program in the United States (behind Social Security) with 42 million beneficiaries and total annual expenditures of \$333 billion in FY 2005. Today, Medicare comprises 13 percent of federal government spending but by 2030, the Congressional Budget Office estimates that on its current path Medicare will consume nearly 25 percent of the federal budget. When combined with Social Security, the two programs will consume more than half of all federal spending by the time today’s newborns turn 40.

As currently structured, Medicare is financially unsustainable. Costs are growing faster than the payroll taxes and premiums that finance the program. Costs are also growing faster than the overall economy, and faster than can be reasonably supported by the federal budget unless spending priorities change dramatically.

Three factors will combine to drive up the cost of Medicare over the coming decades. Health care costs are rising faster than wages. Consequently, the payroll

taxes that fund Medicare are falling short of program costs. At the same time, the number of beneficiaries will climb steeply when the baby boom generation begins receiving benefits in 2011. Moreover, people who reach age 65 are living longer. People aged 85 and older are the fastest growing segment of our population. Medicare spending averages more than twice as much for people over 85 as it does for those age 65.

### Medicare Income and Costs as a Percent of GDP



Source: Report of Trustees of the Hospital Insurance Trust Fund, 2006

The addition of Medicare’s prescription drug benefit merely compounds the program’s shaky financial foundation. According to the President’s Office of Management and Budget, the new prescription drug benefit will add \$45 billion to the FY2006 deficit and \$361 billion over the next five years. Indeed, estimates by the administration indicate that the unfunded obligations of the Medicare Part D drug benefit are roughly 50 percent more than those of the entire Social Security program. Congress and the President must look for ways to make the benefit more efficient, better targeted and less expensive.

Putting the Medicare program on a financially sustainable path will require some combination of reductions in services, increased cost-sharing by beneficiaries, increasing the eligibility age, bringing more revenues into the system and improving the cost effectiveness of Medicare and the health care system overall.

ABOUT THE CONCORD COALITION

The Concord Coalition is co-chaired by former U.S. Senators Warren B. Rudman (R-NH) and Bob Kerrey (D-NE). Former Secretary of Commerce Peter G. Peterson serves as President. The Concord Coalition was founded in 1992 by Rudman, Peterson and the late Senator Paul E. Tsongas (D-MA).

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